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# Purchasing QFOBI Assets from the Estate

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## **PURCHASING QFOBI ASSETS FROM THE ESTATE**

— by Neil E. Harl\*

Typically, assets in a qualified family-owned business interest (QFOBI)<sup>1</sup> pass by inheritance to qualified heirs.<sup>2</sup> The statute requires that the aggregate value of the decedent's qualified family-owned business interests exceed 50 percent of the adjusted gross estate (gross estate less allowable deductions), and that amount or more must be "acquired by any qualified heir from, or passed to any qualified heir from, the decedent...."<sup>3</sup> The question is whether QFOBI assets can pass to qualified heirs by purchase with eligibility retained for the family-owned business deduction and, if so, what the income tax consequences of the sale are to a qualified heir or heirs.

### **Purchase of land under special use valuation from the estate**

Many of the provisions of the family-owned business deduction parallel those for special use valuation.<sup>4</sup> For purposes of special use valuation, the statute specified that, for eligibility for the provision, it was necessary for qualified real property to be "acquired from or passed from the decedent to a qualified heir of the decedent."<sup>5</sup> Until a 1981 amendment was enacted, property was deemed to have been acquired from the decedent if so considered under I.R.C. § 1014(b) which meant that land was ineligible if purchases occurred or options were exercised before the land passed to the qualified heirs.<sup>6</sup> The fact that the title to realty passed immediately to the heirs as a matter of state law subject to being retaken by the estate representative to pay debts and costs apparently was sufficient to meet the test.<sup>7</sup>

The 1981 amendment, retroactive to January 1, 1977, permits property to pass by purchase and not lose eligibility for special use valuation.<sup>8</sup> Under the 1981 amendment, land is considered to have been acquired from or to have passed from the decedent if—(1) the property is so considered to have passed under I.R.C. § 1014(b) relating to income tax basis of property acquired from the decedent; (2) the property is acquired by "any person" from the estate; or (3) the property was acquired by "any person" from a trust (to the extent the property was includible in the decedent's estate).<sup>9</sup>

### **Purchase of qualified family-owned business interests**

Under the provision for a deduction for qualified family-owned business interests, the assets are eligible for a deduction if the qualified family-owned business interests "...are acquired by any qualified heir from, or passed to any qualified heir from, the decedent...."<sup>10</sup> That statement is conditioned by the qualifying requirement that the passage must be within the meaning of I.R.C. § 2032A(e)(9).<sup>11</sup> That is the passage, added in 1981, that allowed property to pass from the estate to qualified heirs by purchase from the estate for purposes of special use valuation.<sup>12</sup> That assures that

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property can pass by purchase and not lose eligibility for purposes of the family-owned business deduction *if the purchase transaction meets any one of the three tests applicable to special use valuation purchases from the estate*.<sup>13</sup>

#### What about the income tax basis?

I.R.C. § 1040, enacted to solve problems of income tax basis where land is purchased from the estate, assures that the only gain recognized to an estate in the event of a sale or taxable exchange by the estate is the difference between the fair market value on disposition and the federal estate tax value.<sup>14</sup> That provision was needed for special use valuation because, otherwise, the difference between the special use value and the value on disposition would be taxable gain to the estate.

In the case of the family-owned business deduction,<sup>15</sup> a basis is assured for the assets comprising the qualified family-owned business interest (or for the entity holding those assets) equal to the fair market value at death<sup>16</sup> or the alternate valuation date.<sup>17</sup> Therefore, the gain recognized on sale of qualified family-owned business interests is the difference between the federal estate tax value (fair market value at death or the alternate valuation date) and the value on sale or taxable exchange. If the purchase of assets from the estate is at the federal estate tax value (and fair market value on purchase is no greater than the federal estate tax value), there should be no gain on sale by the estate to a qualified heir or heirs.<sup>18</sup>

#### Repeal of the family-owned business deduction

The family-owned business deduction does not apply to estates of decedents dying after December 31, 2003.<sup>19</sup> Thus, it appears that the provision *will remain in effect for purposes of recapture for estates of decedents dying before January 1, 2004*, if an election was made under I.R.C. § 2057.

#### FOOTNOTES

<sup>1</sup> See I.R.C. § 2057(e). See generally 5 Harl, *Agricultural Law* § 44.03 (2002); Harl, *Agricultural Law Manual* §

5.04[7] (2002). See also Harl and McEowen, "The Family-Owned Business Deduction—Section 2057," TM 829-2nd *BNA-Tax Management* (2001).

<sup>2</sup> See Harl and McEowen *supra* note 1 at A-10.

<sup>3</sup> I.R.C. § 2057(b)(2)(B).

<sup>4</sup> See I.R.C. § 2032A. See also 5 Harl, *Agricultural Law* § 44.03 (2002).

<sup>5</sup> I.R.C. § 2032A(b)(1).

<sup>6</sup> Cf. *Valleskey v. Nelson*, 271 F.2d 6 (7th Cir. 1959); *Kalbac v. Comm'r*, 298 F.2d 251 (8th Cir. 1962). See Ltr. Rul. 8110023, Nov. 28, 1980 (farmland ineligible where devisees contributed funds to pay other bequests and costs of estate settlement).

<sup>7</sup> Ltr. Rul. 814008, June 24, 1981.

<sup>8</sup> I.R.C. § 2032A(e)(9). See Ltr. Rul. 8206050, Oct. 22, 1981 (land eligible for special use valuation even though qualified heirs "purchased" land from estate by assuming mortgage placed on property by executor to enable cash distributions to be made to other qualified heirs); Ltr. Rul. 8217075, Jan. 28, 1982 (stock redeemed under I.R.C. § 303 deemed to have met "passing from" requirement).

<sup>9</sup> I.R.C. § 2032A(e)(9).

<sup>10</sup> I.R.C. § 2057(b)(2)(B).

<sup>11</sup> *Id.*

<sup>12</sup> See note 9 *supra* and accompanying text.

<sup>13</sup> I.R.C. § 2032A(e)(9). See note 9 *supra* and accompanying text.

<sup>14</sup> I.R.C. § 1040(a).

<sup>15</sup> I.R.C. § 2057.

<sup>16</sup> See I.R.C. § 1014(a).

<sup>17</sup> I.R.C. § 2032(a).

<sup>18</sup> See I.R.C. § 1040(a).

<sup>19</sup> I.R.C. § 2057(j), added by Pub. L. No. 107-16, Sec. 521(d).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### BANKRUPTCY

#### CHAPTER 12-ALM § 13.03[8].\*

**LEGISLATION.** On December 19, 2002, the President signed a six-month extension through June 30, 2003 for Chapter 12 bankruptcy.

#### FEDERAL TAX-ALM § 13.03[7].\*

**DISCHARGE.** The debtor had invested in a corporation which operated video stores. The officers and employees of

the business failed to operate the stores in a business-like manner and the debtor's investment was lost. The debtor claimed the losses as capital loss deductions on the debtor's income tax returns but the IRS disallowed most of the deduction and recharacterized it as a non-capital loss. The debtor did not have complete records to substantiate the claimed losses and the final allowed amounts were determined by agreement with the IRS. At no time did the IRS charge the debtor with fraud in the filing of the tax returns. The debtor filed for Chapter 7 more than three years after the return was filed and sought to have the tax deficiency declared dischargeable. The IRS argued that the debtor's claim of unsubstantiated losses was a willful attempt to evade taxes or resulted in a fraudulent return and made the